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RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
RUEHBS/USEU BRUSSELS PRIORITY

C O N F I D E N T I A L SECTION 01 OF 03 BAKU 000155

SIPDIS

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DEPT FOR EB A/S SULLIVAN, SCA PDAS MANN, AND EUR DAS BRYZA

E.O. 12958: DECL: 01/31/2017
TAGS: ENRG EPET PREL ECON ETRD RU TU AJ
SUBJECT: SCENESETTER FOR A/S SULLIVAN'S FEBRUARY 7 ENERGY
TALKS IN BAKU

REF: BAKU 98

Classified By: Ambassador Anne E. Derse per 1.4 (b,d).

¶1. (C) SUMMARY: The U.S-Azerbaijani Energy dialogue comes at a crucial time in the development of Azerbaijan's energy sector, when production from major oil and gas projects has either started or will start soon, and when Azerbaijan needs to make strategic decisions that will affect both the future development of its energy sector and global energy security. Heavy-handed Russian pressures, to include Gazprom more than doubling its proffered gas price for 2007 while significantly reducing amounts offered, have encouraged the GOAJ to increase its efforts for energy independence from Moscow and, more generally, to seek to strengthen its energy ties to the West. The October 2006 "Memorandum of Understanding on a Strategic Partnership between the European Union andthe Republic of Azerbaijan in the Field of Energy," was an significant step in this regard. In the gas sector, major issues to be addressed include beginning a discussion with Turkey on a gas transit regime that will facilitate transit of Caspian gas first to Greece and eventually to other European countries; and Azerbaijan proving up its own gas reserves, to include 'deep gas' associated with the ACG field, so that commercial decisions can be made this year that will allow pipeline construction and subsequent delivery of significant amounts of gas to Europe starting o/a 2012. Discussions with Turkmenistan and/or Kazakhstan about gas shipment westward across the Caspian and through to Europe should be another GOAJ-US focus. In the oil sector, the GOAJ needs to increase efforts by the relevant governmental agencies with commercial and government interlocutors in Kazakhstan to reach agreement on an HGA to follow up on the July 2006 IGA, so that Kazakhstan,s North Caspian oil can link to the Baku-Tbilisi-Ceyhan pipeline. The public launch of our new high-level Dialogue on Energy Security in the Caspian Region will be a strong show of USG support for Azerbaijan,s efforts to strengthen southern corridor routes.
END SUMMARY.

OIL ) ACG/BTC
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¶2. (C) Estimates of Azerbaijan's proven crude oil reserves range between 7 to 13 billion barrels. The bulk of Azerbaijan's oil production comes from Azerbaijan International Operating Company (AIOC), which represents over 70 percent of Azerbaijan total oil exports. Current oil production is dominated by the BP-operated offshore

Azeri-Chiraq-Gunashli (ACG) field, with its estimated minimal recoverable 5.4 billion barrels of oil. First oil production from this major field began in 1997, and July 2006 saw the official inauguration of the 1,768 kilometer BTC pipeline built to carry ACG oil through Georgia to Turkey. By the end of 2006, this pipeline was carrying an average of over 500,000 bpd, with a goal of 800,000 bpd for 2007. Production from the ACG field is expected to peak by approximately 2012; proper management of the expected approximately USD 250 billion of energy-based revenues over the next decade in oil revenue is one of the GOAJ,s greatest challenges.
Production of this field and of other major energy projects has been regulated by Production Sharing Agreements between the GOAJ and major energy companies, to which the government has largely adhered.

¶3. (C) In addition to the BTC, the AIOC continues to use the 100,000 b/d Northern Route Export Pipeline (Baku-Novorossiisk and a rail link to Batumi Terminal in Georgia. Repairs needed on the 155,000 b/d Western Early Oil (Baku-Supsa) pipeline have forced BP to transfer oil intended for this pipeline to either rail to Batumi or the Northern Route Export pipeline. BP is at the start of discussions with the GOAJ concerning extension of its current PSA to allow for optimal development of ACG, and for development of the substantial amounts of associated ACG 'deep gas.'

HGA/IGA
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¶4. (SBU) In June 2006 Azerbaijan President Aliyev and Kazakhstan President Nazarbayev signed an IGA to facilitate a link by tanker between Kazakhstan,s North Caspian oil fields



and the Baku-Tbilisi-Ceyhan (BTC) pipeline. However, the price of consensus on this IGA was delaying agreement on unresolved issues such as oil volumes, tariffs and control of shipping fleets, to subsequent Host Government Agreements (HGA). There has been no substantive progress on an HGA since the June 2006 signing, in part because the GOAJ has not seen the issue as a pressing one. However, for oil volumes from Tengiz and ultimately Kashagan begin to cross the Caspian to make their way westward, the GOAJ will need to resolve the multitude of outstanding issues relating to the HGA.

GAS ) SHAH DENIZ
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¶5. (C) Azerbaijan's major gas field is the offshore Shah Deniz field, developed by a seven-member consortium with BP as operator. According to BP, Shah Deniz contains potential recoverable resources of roughly 35 trillion cubic feet of gas and 750 million barrels of condensate, making it one of the world's largest natural gas field discoveries of the last twenty years. There have been production delays in the first stage of Shah Deniz, which was to have begun production late 2006 and which is supposed to have peak production of approximately 8.4 billion cubic meters annually. In mid-December 2006, a leak in the first of the four wells to be developed caused production to shut down shortly after it started, with current BP plans for the second well to begin production in late February/early March, followed four to six weeks later by the start of the third well and then four to six weeks later by the fourth well, after which repairs on the first well will resume.

07 WINTER GAS SHORTAGE
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¶6. (C) These Shah Deniz production delays exacerbated problems on how Azerbaijan and Georgia were to face the regional gas shortage this winter. For reasons largely seen as political, traditional supplier Gazprom had significantly raised its offered price to both Georgia and Azerbaijan for

2007 gas, in the latter case from 110 dollars per thousand cubic meters in 2006 to 235 dollars in 2007, while lowering the offered amount from 4.5 to 1.5 billion cubic meters. In response, Turkey, Georgia and Azerbaijan,s governments began the discussion in November 2006 of redistributing Shah Deniz gas intended for Turkey in 2007 to Georgia and Azerbaijan, but talks hung up over the issue of how Turkey was to be compensated. The unexpected mid-December shutdown of the first Shah Deniz well (and the subsequent gas purchase of major Georgia consumers from Gazprom) brought these discussions to a functional standstill. Azerbaijan compensated for its domestic gas shortage by exporting decreased amounts of oil and converting it to heavy fuel to be used in its own power plants. This process, although resulting in a major income loss for the GOAJ, allowed the government to do without Gazprom gas for the 07 winter. To help the GOAJ and to minimize ill will, BP consented to give the government as much associated gas from the ACG field as it technically could, this gas being free under the terms of the PSA, despite having earmarked much of this gas for reinjection. BP has made clear that it will give these extra amounts of ACG associated gas to SOCAR only for the first quarter of FY 07, after which it will resume reinjection into ACG, to maintain the health of the reservoir.

TURKISH GAS TRANSIT REGIME
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¶7. (C) Shah Deniz gas is destined to move through Azerbaijan and Georgia to the Turkish border via the South Caucasus Pipeline (SCP). However, Botas has not yet completed construction within Turkey, and it is unclear whether it will be able to finish construction, commission the pipeline and begin requesting amounts of Shah Deniz gas before spring. Regardless of when Turkey is ready to receive Shah Deniz gas, the GOAJ needs to begin discussions with Turkey concerning an equitable transit regime that will allow Azerbaijani, and ultimately Kazakh and/or Turkmen gas, to transit to Europe through Turkey. GOAJ perceptions are that Turkey seeks to play the role of a "mini-Gazprom," buying and selling Caspian gas, and GOAJ interlocutors have said that the GOAJ will sell



gas "through but not to" Turkey.

MARKETS FOR CASPIAN GAS
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¶8. (C) Except for a token amount for Greece, most of the production from Shah Deniz Stage One is earmarked for Turkey, Azerbaijan and Georgia. Currently BP is drilling the SDX-04 exploratory well in the southern part of the Shah Deniz field, which when completed in a few months will give an indication of how much gas can be expected for Shah Deniz Phase Two. Baseline projections for Shah Deniz Phase Two are approximately 12 bcm/a, with much of this production earmarked for the Azerbaijan and Georgia. However, market expectations are that some amounts of Shah Deniz Phase Two production will be available for transmission through Turkey. The Austrian OMV consortium, seeking a minimum of ten bcm from Azerbaijan so that it can secure funding for its Nabucco pipeline, made its first high-level visit to Azerbaijan in January 07, and is expected to be returning regularly. The Italian company Edison and the Greek Gas company DEPA have also engaged the GOAJ in connection with the Turkey-Greece-Italy (TGI) interconnector project.

¶9. (C) However, for there to be appreciable amounts of Azerbaijani gas for supply to Europe, either through the Turkey-Greece Interconnector (TGI) or the Nabucco pipeline, Azerbaijan needs to begin to prove up its reserves, to include "ACG Deep Gas," which BP says could have half-as much or greater than the approximately 35 trillion cubic feet of gas in Shah Deniz. In addition to Azerbaijani gas, gas from Turkmenistan and/or Kazakhstan could be used to satisfy European demand, and as such we need to work with the GOAJ as

to how best to approach these two countries to explore the possibility of westward transmission of their gas.

COMMENT
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¶10. (C) In recent weeks, the GOAJ has dramatically changed its previously discrete public posture on prospects for new gas sales to Europe. In a blunt Wall Street Journal editorial, Foreign Minister Mammadyarov rejected Russian gas tactics as &unacceptable8 and argued that new Caspian gas sales to Europe would provide protection against &market bullies." At the same time, Mammadyarov also requested that we create a new, high-level bilateral dialogue on energy security that would address the political aspects of new transport routes (reftel). In our view, the GOAJ has made a strategic decision to cast its energy future with the West; the launch of this new energy security dialogue at the Economic Partnership Commission will be an important public show of support for Azerbaijan,s decision.
DERSE